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Lexington-Fayette Urban County Government **March 31, 2006**
Department Of Law
200 East Main Street
Lexington, KY 40507

CERTIFICATE OF SERVICE

RE: Case No. 2003-00434
Kentucky Utilities Company

I, Beth O'Donnell, Executive Director of the Public Service Commission, hereby certify that the enclosed attested copy of the Commission's Order in the above case was served upon the addressee by U.S. Mail on March 31, 2006.

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Enclosure



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COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN ADJUSTMENT OF THE ELECTRIC)
RATES, TERMS, AND CONDITIONS OF) CASE NO. 2003-00434
KENTUCKY UTILITIES COMPANY)

O R D E R

On August 12, 2004, the Commission issued an Order granting in part the petition for rehearing filed by the Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention ("AG"). The AG requested rehearing on four issues that were decided by the Commission's June 30, 2004 Order in conjunction with the calculation that Kentucky Utilities Company ("KU") had a revenue deficiency of \$49,775,329. The Commission granted rehearing on one issue, which was whether KU's revenue deficiency should have been calculated by using the effective Kentucky income tax rate, as proposed by the AG, rather than the statutory Kentucky income tax rate, as proposed by KU. The scope of rehearing on this issue includes not only the appropriateness of using an effective Kentucky income tax rate, but also what that rate is and whether its use would have impacted the amount of additional revenue actually granted by the June 30, 2004 Order.

The Commission's December 15, 2005 Order established a procedural schedule providing for discovery and a date by which the parties could either file memoranda or request an evidentiary hearing. No party requested an evidentiary hearing. KU and the

AG filed memoranda in support of their respective positions on the tax issue and these cases now stand submitted for a decision.

AG's Position

On March 3, 2006, the AG filed a joint memorandum in this case and in the pending Louisville Gas and Electric Company ("LG&E") rate case,¹ arguing that use of the effective Kentucky income tax rate is a benefit flowing from the merger of the "Companies" and "their" ability to file a consolidated income tax return.² He contended that the effective Kentucky income tax rate should be utilized even though he acknowledges that it lacks the certainty of the statutory Kentucky income tax rate. The AG noted that the statutory Kentucky income tax rate is higher than the effective Kentucky income tax rate for KU in 2002 and that the statutory tax rate does not reflect the actual income tax KU will pay while the existing electric rates are in effect. The AG argued that using the effective Kentucky income tax rate would be consistent with the Commission's most recent rate decisions for The Union Light, Heat and Power Company ("ULH&P") and Kentucky-American Water Company ("Kentucky-American").³

The AG also acknowledged that if the effective Kentucky income tax rate is used, the resulting change in KU's revenue deficiency would not change the level of additional revenue granted to KU since KU had agreed to accept less revenue than the

¹ Case No. 2003-00433, An Adjustment of the Gas and Electric Rates, Terms, and Conditions of Louisville Gas and Electric Company.

² AG's Memorandum on Petition for Rehearing at 1.

³ The AG cited Case No. 2001-00092, Adjustment of Gas Rates of The Union Light, Heat and Power Company, final Order issued January 31, 2002 and Case No. 2004-00103, An Adjustment of the Rates of Kentucky-American Water Company, final Order issued February 28, 2005.

Commission had calculated as the revenue deficiency. However, the AG urged the Commission to adopt the effective Kentucky income tax rate for calculating KU's revenue deficiency and, thereby, establish the proper methodology for this adjustment, just as the Commission established the proper methodology for all other adjustments addressed in the June 30, 2004 Order.⁴

KU's Position

KU's March 3, 2006 rehearing memorandum, filed jointly here and in Case No. 2003-00433, reiterated its prior position that it is appropriate to utilize the statutory Kentucky income tax rate to calculate its revenue deficiency and that the Commission's June 30, 2004 Order was correct in utilizing that methodology. KU noted that the effective Kentucky income tax rate is not only subject to fluctuations due to changes in property, payroll, and sales factors, but is also continuously impacted by tax credits and out-of-state activities which make its use more uncertain and complicated than the statutory rate. KU characterized the Kentucky statutory income tax rate as being "objective, known and measurable, easily understood and verified, and not distorted by non-recurring items or apportionment adjustments from out-of-state activities."⁵

While contending that the statutory Kentucky income tax rate should be utilized, KU stated that if an effective Kentucky income tax rate is used for its operations, the appropriate effective rate is 7.98 percent, based on a Kentucky jurisdictionalized basis.⁶

⁴ AG's Memorandum on Petition for Rehearing at 2.

⁵ KU's and LG&E's Memorandum Opposing Use of Effective Tax Rates at 2.

⁶ KU Rehearing Response to Commission Staff, filed January 20, 2006, Item No. 2.

Since KU serves customers in Kentucky, Virginia, and Tennessee, KU asserts that a Kentucky jurisdictional only effective tax rate is appropriate since it matches KU's activities that benefit Kentucky customers with the Kentucky income tax cost of only those activities. Using this effective income tax rate, KU recalculated its revenue deficiency to demonstrate that the revenue increase needed would still fall within the range of the revenue increase calculated as reasonable by the Commission's June 30, 2004 Order. Based upon this analysis, KU argued that even if the effective Kentucky income tax rate is used, the Commission's calculation of KU's revenue deficiency would still exceed the revenue increase authorized by the June 30, 2004 Order.

KU's March 13, 2006 joint reply rehearing memorandum claims that the AG has rendered moot his own argument to use KU's effective Kentucky income tax rate by acknowledging that to do so would not change the amount of additional revenue authorized by the June 30, 2004 Order. KU further claims that the ULH&P and Kentucky-American rate cases cited by the AG are distinguishable here because KU did not agree to use the effective Kentucky income tax rate in the determination of its revenue requirements and revenue increases.⁷

FINDINGS

Based on the evidence of record and being otherwise sufficiently advised, the Commission finds that our June 30, 2004 Order set forth a complete analysis of all proposed rate-making adjustments. Based on that analysis, including the decision therein to use the statutory Kentucky income tax rate, we determined that KU had a revenue deficiency of \$49,775,329. Although KU would have been entitled to increase

⁷ KU's and LG&E's Memorandum Opposing Use of Effective Tax Rates at 3-4.

its revenues by that same amount, the Commission recognized KU's agreement, as set forth in the Partial Settlement Agreement, Stipulation, and Recommendation, to accept a lesser increase in its revenues. That lesser increase, which was granted by the Commission, was \$46.1 million.

A recalculation of KU's revenue requirements based on its 2002 jurisdictionalized effective Kentucky income tax rate of 7.98 percent, rather than the statutory rate of 8.25 percent as previously used, would have reduced KU's revenue deficiency from \$49,775,329 to \$49,359,219. Since this recalculated deficiency still exceeds the \$46.1 million revenue increase granted by the Commission in accordance with KU's agreement, the AG's proposed tax adjustment would have no impact on the amount of revenue increase granted by the June 30, 2004 Order. Thus, the AG's proposal on rehearing to use KU's effective Kentucky income tax rate is a moot issue. However, even though the AG's proposed tax adjustment is a moot issue, we will address the merits of the adjustment since the adjustment was previously analyzed and rejected in the June 30, 2004 Order.

The Commission is not persuaded that the two previous rate decisions cited by the AG establish a precedent for requiring the use of the effective Kentucky income tax rate over the objections of KU in this rate case. In the ULH&P gas rate case cited by the AG, the Commission did not require ULH&P to use the effective Kentucky income tax rate. Rather, ULH&P proposed to do so and the Commission accepted the proposal, but only on a trial basis due to concerns that there can be significant fluctuations in the effective rate. Specifically, the Commission stated that:

This is the first proceeding in which the Commission has considered the use of the effective, rather than the

stated, Kentucky income tax rate. The Commission has some concerns about using this approach, especially since the effective rate changed from 5.15 to 3.03 percent between two tax years. However, the Commission will accept the use of the effective Kentucky income tax rate of 3.03 percent in this proceeding, and will reflect that rate in the determination of ULH&P's revenue requirements. . . .

The Commission is accepting the use of the effective Kentucky income tax rate on a trial basis. In ULH&P's next rate case, it should provide an analysis showing the effective Kentucky income tax rates experienced by ULH&P for the tax years between 2000 and the current tax year applicable to its application. The Commission will review this information at that time to determine whether the use of the effective rate should continue.

Case No. 2001-00092, January 31, 2002 Order at 59-60. Since issuing that Order, ULH&P did file a subsequent gas rate case which included the required analysis of its effective Kentucky income tax rate. ULH&P concluded from its analysis that:

The effective Kentucky income tax rate could vary substantially from year-to-year. Notwithstanding ULH&P's last gas base rate case, the Commission has historically and consistently used the Kentucky statutory tax rate in past cases. ULH&P believes that the Commission's use of the statutory rate is the most proper approach and should be applied in this case as well. The statutory rate is known, easily verifiable and not distorted by non-recurring items or apportionment adjustments attributable to other entities participating in the filing of a consolidated tax return.⁸

The AG actively participated in that subsequent ULH&P gas rate case, but neither he nor ULH&P proposed to use the effective Kentucky income tax rate and the Commission did not require its use. The Commission calculated ULH&P's gas revenue deficiency based on the AG's proposal therein to use a 7.00 percent statutory Kentucky

⁸ Case No. 2005-00042, An Adjustment of the Gas Rates of The Union Light, Heat and Power Company, Direct Testimony of Alexander J. Torok, at 7.

income tax rate.⁹ Thus, contrary to the AG's claims, the Commission used the statutory Kentucky income tax rate, not the effective rate, to determine the revenue requirements and revenue increase in the most recent ULH&P rate case.

In the Kentucky-American rate case cited by the AG, the AG had proposed a federal "consolidated income tax" adjustment which would have prospectively allocated tax losses to companies that generated positive taxable income. The AG's proposed adjustment was calculated using a 3-year average of tax losses and the statutory federal income tax rate.¹⁰ However, the income tax effect of the AG's adjustments in that case reflected the use of the statutory federal and Kentucky income tax rates. The Commission accepted the AG's federal consolidated tax adjustment based on a voluntary commitment, previously made by Kentucky-American in conjunction with its acquisition by RWE, that it would be able to file consolidated tax returns and achieve tax savings by doing so. As the Commission stated in that Kentucky-American rate case:

Having previously indicated the savings resulting from the filing of a consolidated tax filing would be viewed as a merger benefit, subject to allocation, we do not believe that acceptance of the AG's proposal represents a radical departure from past regulatory practice. Moreover, Kentucky-American and its corporate parents having previously touted TWUS's filing of consolidated tax returns as a benefit to obtain approval of the merger transaction, have no cause to object if we now act upon their representation. Accordingly, we find that the AG's proposed consolidated income tax is reasonable and have reflected it in our calculation of federal income taxes.¹¹

⁹ Case No. 2005-00042, December 22, 2005 Order at 50.

¹⁰ Case No. 2004-00103, Crane Direct Testimony at 74-75 and Schedule ACC-39.

¹¹ Case No. 2004-00103, February 28, 2005 Order at 65-66.

In the Kentucky-American rate case, the Commission adopted a dollar adjustment to the federal tax expense, but the statutory federal and Kentucky income tax rates were utilized to determine the revenue requirements and revenue increase. The AG did not propose to use an effective federal or Kentucky income tax rate in that case and the Commission did not require its use. Furthermore, the AG has not now cited any commitment, obligation, or representation by KU that it would use an effective Kentucky income tax rate or otherwise share with ratepayers the benefits of a consolidated tax return.

The Commission has previously expressed concerns about using an effective Kentucky income tax rate due to the annual fluctuations in the effective rate.¹² These fluctuations occur because the effective Kentucky income tax rate is determined from the total of all the tax income and tax losses of all the entities that file on the same consolidated income tax return. For KU, the majority of the entities other than LG&E included in the consolidated income tax return of KU's parent corporation, E.ON US Investment Corp., reflect activities which are not regulated by the Commission. By having to recognize tax losses and other tax credits related to these non-regulated activities to derive an effective Kentucky income tax rate could well be viewed as forcing the utility to use these non-regulated activities to subsidize the regulated utility operations. There is also a concern that because of the way the apportionment of certain tax transactions is performed, the resulting effective Kentucky income tax rate could exceed the statutory Kentucky income tax rate. Thus, establishing the effective

¹² Case No. 2001-00092, January 31, 2002 Order.

tax rate as the guideline or precedent, as the AG has requested on rehearing, could in the future result in higher utility rates to pay for taxes on non-regulated activities.

There also appears to be a serious timing issue related to the utilization of an effective Kentucky income tax rate. Corporate tax returns are not due until 9 months after the end of the tax year, and the effective income tax rate cannot be determined until after the consolidated tax returns have been filed. The most recent effective Kentucky income tax rate that was available when this case was decided was for the 2002 tax year, even though the test year was the 12 months ending September 30, 2003 and the new rates were to be effective prospectively starting July 1, 2004. Under these facts, the Commission finds that it is not reasonable to calculate rates to be effective post-July 1, 2004 based on a 2002 effective tax rate which is subject to annual changes based on non-regulated activities.

The Commission further finds it reasonable to continue using the statutory Kentucky income tax rate for determining KU's revenue requirements in this case. The statutory Kentucky income tax rate is known and measurable and is not subject to fluctuations due to non-regulated tax losses or tax credits, or due to apportionment adjustments from non-regulated activities. The Commission has consistently utilized the statutory Kentucky income tax rate to determine utility revenue requirements absent an agreement or representation to the contrary by the utility. Here, the AG has not provided sufficient evidence to persuade us to modify our June 30, 2004 decision to calculate KU's revenue requirements based on the statutory Kentucky income tax rate.

The Commission did previously direct KU to address in detail the use of the effective Kentucky income tax rate for rate-making purposes in its next rate case. KU

acknowledged this requirement in its joint reply memorandum, and the Commission will now reaffirm KU's obligation to do so as part of its next rate case. By the time its next rate case is filed, KU will have more experience with filing Kentucky consolidated income tax returns and the issue of whether to use the effective Kentucky income tax rate and, if so, what the appropriate effective rate is, can be revisited at that time.

In summary, the Commission finds that it is not appropriate to utilize the effective Kentucky income tax rate to determine KU's revenue requirements and revenue increase in this case, and the AG's proposal is denied. As a result of this finding, there are no changes to KU's revenue requirements, revenue deficiency, or the amount of revenue increase found reasonable in the June 30, 2004 Order.

IT IS THEREFORE ORDERED that the AG's proposal to use the effective Kentucky income tax rate to determine KU's revenue requirements and the amount of its revenue increase in this case is denied.

Done at Frankfort, Kentucky, this 31st day of March, 2006.

By the Commission

ATTEST:



Executive Director